QUESTIONS PRESENTED

1. Whether the courts below correctly ruled that the allegations of petitioner's complaint were insufficient to excuse her failure to make a demand upon Cash Equivalent Fund, Inc. ("the Fund") before bringing this action, in which she alleges no fraud by the Fund's directors, seeks no relief against the Fund, and claims only that certain correct information included in a proxy statement distributed by the Fund created a "false impression" in connection with a comparison of fees charged by the Fund's investment adviser?

2. Whether, as a matter of federal common law and policy, the "futility" exception to the pre-suit demand requirement in federal shareholder derivative litigation should be abolished?

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1990

No. 90-516

JILL S. KAMEN,

Petitioner,

v.

KEMPER FINANCIAL SERVICES, INC. and CASH EQUIVALENT FUND, INC.,

Respondents.

On Writ of Certiorari
To the United States Court of Appeals
For the Seventh Circuit

BRIEF FOR RESPONDENT CASH EQUIVALENT FUND, INC.

STATEMENT OF THE CASE

Petitioner Jill S. Kamen is a shareholder in respondent, Cash Equivalent Fund, Inc. (the "Fund"), a money market mutual fund registered as an investment company under the Investment Company Act of 1940, 15 U.S.C §§80a-1 *et seq.* (1981) ("the 1940 Act").* Respondent Kemper Financial Services, Inc. ("KFS"), is the Fund's investment adviser, manager and underwriter.

* Pursuant to Supreme Court Rule 29.1, respondent Cash Equivalent Fund, Inc. states that it has no parent or subsidiary company.

Petitioner's suit, a one-count action filed "on behalf of the Fund" in May, 1985, alleged that KFS and the Fund violated sections 20(a) and 36(b) of the 1940 Act, 15 U.S.C. §§80a-20(a), 80a-35(b). She asserted that KFS and the Fund sent shareholders a proxy statement that contained a single sentence which gave a "false impression" of the fees charged to the Fund. She also claimed that KFS had breached its fiduciary duty to the Fund by charging excessive fees for its advisory and management services.

Petitioner sought no relief against the Fund, nor did she join the Fund's directors as defendants. Petitioner made no particularized allegations of self-dealing or other wrongdoing against the Fund's directors, but claimed that pre-suit demand upon the Fund was excused on futility grounds.

Respondent KFS has set forth in its brief on this appeal a complete, concise and accurate statement of the parties' contentions and arguments in both lower courts that decided this case.

The Fund adopts respondent KFS's statement of the case on this appeal and, in deference to the Court, will not repeat it here.

SUMMARY OF THE ARGUMENT

The district court and the Seventh Circuit Court of Appeals each correctly concluded that petitioner's section 20(a) claim should be dismissed because she did not plead facts sufficient to excuse her failure to make pre-suit demand upon the Fund.

The district court, consistent with well-settled law, ruled that demand could be excused only where the complaint contained particularized allegations of director wrongdoing or self-interest. Petitioner's allegations of demand futility were thin indeed, and completely lacked the particularity

required under Rule 23.1, Fed. R. Civ. P., and a long line of established federal precedent. Both courts below correctly applied federal common law. However, petitioner's allegations of demand futility would likewise not meet the mark under Maryland law, which petitioner only lately argues should supply the substantive requirement of demand. Where, as in the instant case, petitioner's generalized and conclusory allegations were simply insufficient to make a showing that the directors could not act in a fair and impartial manner, the case should not proceed.

The Seventh Circuit agreed that the complaint, as finally amended, did not plead futility with the requisite particularity to survive respondents' Rule 23.1 challenge. The appeals court, however, found an additional and equally compelling reason to affirm. After a careful analysis of the rationale underlying the demand rule and its history from *Hawes v. Oakland*, 104 U.S. 450 (1881) to the present, the court noted that the futility exception to the demand rule in shareholder derivative litigation has generated a considerable body of litigation which has done little to advance the goals the rule was designed to achieve. It has sapped the rule of its energy by requiring litigants and the judiciary to speculate on fact-specific issues which customarily have little or nothing to do with the merits of the litigation. The demand rule has been transmogrified, by reason of its futility exception, from its genesis in federal common law as an exhaustion requirement, into a weapon by which dissident shareholders and their counsel seek to wrest management decisions from the directors to whom such decisions are properly entrusted. The Seventh Circuit correctly concluded that the exception had swallowed the rule, and should be removed from consideration in federal cases as a matter of federal common law.

It is now time to reinvest the demand rule with the vigor intended by this Court when it fashioned the requirement, recognizing, as the Seventh Circuit did, the evolution of methods and principles of modern business management. It also must be made clear that federal courts will enforce the demand requirement in federal rights cases, so that the precious resources of the courts will no longer be squandered in long and costly disputes before the merits of such cases are ever reached. The consequence of the evolutionary step taken by the Seventh Circuit will be to streamline shareholder derivative litigation.

Adoption of the demand requirement set forth by the Seventh Circuit will put the responsibility for corporate decision-making where it belongs in the first place, while enabling corporate shareholders and federal courts to concentrate their resources on the functions for which each is best suited.

As an *amicus* to these proceedings, the Securities and Exchange Commission ("SEC") seeks a reversal of the lower court decisions arguing that petitioner's claim is not derivative for purposes of Rule 23.1. This argument is not properly before this Court, inasmuch as petitioner has maintained throughout all phases of this litigation that her section 20(a) claim *is* derivative for purposes of Rule 23.1. Moreover, the effect of the ruling proposed by the SEC will be to prevent corporations from litigating important corporate rights.

ARGUMENT

Petitioner's allegations of director interest or involvement have twice been held insufficient to excuse pre-suit demand under federal law, initially by the district court (Pet. App. 50a-56a) and subsequently by the Seventh Circuit Court of

Appeals (Pet. App. 6a).[1] As an additional ground for dismissing petitioner's section 20(a) claim, the Seventh Circuit held as a matter of federal common law that allegations of futility could no longer excuse a shareholder's failure to bring pre-suit demand (Pet. App. 14a-15a). The district court's determination that petitioner failed to plead allegations of director interest sufficient to excuse demand is, and should be, dispositive of this appeal.

I. PETITIONER'S ALLEGATIONS OF FUTILITY FAIL TO EXCUSE DEMAND UNDER BOTH FEDERAL AND MARYLAND LAW

In light of the conclusory and unsupported nature of petitioner's allegations of futility, there is no basis for disturbing the district court's determination that they were insufficient to excuse demand. *See Lewis v. Graves*, 701 F.2d 245, 248 (2d Cir. 1983) ("decision as to whether a plaintiff's allegations of futility are sufficient to excuse demand depends upon the particular facts of each case and lies within the discretion of the district court."); *Lewis v. Curtis*, 671 F.2d 779, 782 (3d Cir.), *cert. denied*, 459 U.S. 880 (1982). For this reason, the Seventh Circuit's affirmance of

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[1] Neither the district court nor the court of appeals considered the issue, belatedly raised by petitioner, of the impact of Maryland's demand futility rules on the resolution of this case. The district court did not consider this issue because petitioner did not present it. Indeed, petitioner's filings to the district court all suggested that federal law should apply. The Seventh Circuit did not consider the issue of Maryland law because petitioner did not mention it until her reply brief (Pet. App. 8a-9a), and even then, did not argue that Maryland law should in fact apply. Under these circumstances, petitioner has waived any right to raise the issue of Maryland law before this Court. *See McPhail v. Municipality of Culebra*, 598 F.2d 603, 607 (1st Cir. 1979).

the district court's decision on this ground should be upheld by this Court.

A. Petitioner's Allegations of Director Interest Are Insufficient Under Federal Precedent to Justify a Finding of Demand Futility

Generalized allegations of director interest, such as petitioners, which fail to raise even the slightest inference of bad faith or knowledge of illegal purpose on the part of the Fund's directors, have consistently been rejected by the federal courts as inadequate under Fed. R. Civ. P. 23.1. The district court correctly applied this unanimous federal law in its rejection of each of petitioner's individual allegations of director interest.

First, petitioner asserts in Paragraph 17(b) of her amended complaint (Pet. App. 92a) that futility is demonstrated by the fact that the seven "disinterested" directors receive remuneration for serving as directors of the Fund.[2] The fact of director remuneration does nothing to advance petitioner's argument in support of demand futility. If it did, the exception would swallow the requirement that demand generally be made. Indeed, petitioner's assertion, taken to its logical conclusion, would mandate a determination that

[2] Congress structured the 1940 Act to place the business affairs of investment companies in the hands of disinterested directors—*i.e.*, directors who are not "affiliated" with or "interested" in the investment company, its underwriters or legal counsel. *See* 15 U.S.C. §§ 80a-2(a)(19) and 80a-10(a). Indeed, section 10(a) of the Act mandates that forty percent of an investment company's directors be disinterested as that term is defined by section 2(a)(19).

Seven of the Fund's ten-member board of directors are disinterested.

futility is established whenever any director who is paid for his services participates in a decision which subsequently becomes the subject of shareholder concern.[3] Rule 23.1 would be rendered ineffective by such a proposition.

In Paragraph 17(c) of her amended complaint (Pet. App. 92a-93a), petitioner states that demand futility is demonstrated in this case because the Fund's disinterested directors assisted KFS in the solicitation of the allegedly misleading proxy statement. As the district court aptly noted, however, "courts have consistently held that 'mere approval of challenged conduct is insufficient to render the demand futile.'" (Pet. App. 53a) (quoting *Lewis v. Anselmi*, 564 F. Supp. 768, 772 (S.D.N.Y. 1983)). *See also Gaubert v. Federal Home Loan Bank Board*, 863 F.2d 59, 65 (D.C. Cir. 1988) ("rare is the significant corporate act that has not been 'approved of' or 'acquiesced in' by the board of directors") and cases cited therein. In *Lewis*, 701 F.2d at 248, the First Circuit stated, "[t]he fact that a corporation's

[3] The *ad infinitum absurdum* nature of an argument similar to this was recently recognized by noted commentators in their discussion of the potential impact of the so-called "structural bias theory" on the ability of independent directors to impartially review the merits of derivative litigation. In *The Role of the Board in Derivative Litigation: Delaware Law and the Current ALI Proposals Compared*, 44 Bus. Law. 503, 534 (1989), Dooley and Veasey ask:

> If familiarity breeds acquiescence in litigation matters, will it not do so in other contexts as well. If so, does this not suggest a wholesale abandonment of the business judgment rule in favor of judicial review of every board approval of a management proposal that turns out badly?

By substituting "remuneration" for "familiarity" in the above-quoted passage, the absurdity of petitioner's allegation becomes apparent.

directors have previously approved transactions subsequently challenged in a derivative suit does not inevitably lead to the conclusion that those directors, bound by their fiduciary obligations to the corporation, will refuse to take up the suit." *See also Grossman v. Johnson*, 674 F.2d 115, 124 (1st Cir.), *cert. denied*, 459 U.S. 838 (1982). The recognition of this fact of corporate life has prompted most federal courts to require an additional showing of bad faith or approval with knowledge of illegal purpose. *See Gaubert*, 863 F.2d at 65; *Lewis*, 701 F.2d at 248 ("absent specific allegations of self-dealing or bias on the part of a majority of the board, mere approval and acquiescence are insufficient to render demand futile"); *Greenspun v. Del E. Webb Corp.*, 634 F.2d 1204, 1210 (9th Cir. 1980) ("'[w]here mere approval of a corporate action, absent self-interest or other indication of bias, is the sole basis for establishing the director's "wrongdoing" and hence for excusing demand on them, plaintiff's suit should ordinarily be dismissed.'") (quoting *In re Kauffman Mutual Fund Actions*, 479 F.2d 257, 265 (1st Cir.), *cert. denied*, 414 U.S. 857 (1973)). Based on this precedent, petitioner's simple assertion that the Fund's directors participated in the solicitation of the proxy statement cannot independently support a finding of futility necessary to meet the requirements of Rule 23.1.

As the district court correctly noted (Pet. App. 54a), petitioner's allegations in Paragraphs 17(d) and (e) of her amended complaint (Pet. App. 93a) do not state any facts; rather, they simply make conclusory claims of control and domination. Rule 23.1 requires a shareholder plaintiff to allege "with particularity" the reasons for failure to obtain corporate action on the claim. This requirement of "particularity" has been vigorously enforced. *Grossman*, 674 F.2d at 123. *See also In re Kauffman*, 479 F.2d at 263 (recognizing that Rule 23.1 is an "exceptional rule of pleading, serving a special purpose"). Petitioner's conclusory allegations of control do not factually demonstrate how the Fund's three interested directors will control the decisions of a ten-member board. Such unsupported allegations of "control" are particularly insufficient in excusing demand in situations such as this where the affiliated directors are in the minority. *See In re Kauffman*, 479 F.2d at 264 ("[p]laintiff must allege specific facts demonstrating the unmistakable link between the unaffiliated majority and the affiliated and allegedly wrongdoing minority").

Paragraph 17(f) of petitioner's amended complaint (Pet. App. 93a) alleges that demand would be futile in this case because the Fund moved to dismiss the case on substantive grounds. In fact, the Fund joined KFS's motion to dismiss because petitioner failed to make a demand, and on the additional ground (unrelated to this appeal) that section 36(b) of the Act should be petitioner's exclusive remedy in an action alleging excessive advisers fees. The Fund took no position concerning the merits of petitioner's proxy violation claim. Thus, the Fund's motion provides no indication that its directors would not have fairly and impartially considered a demand. Moreover, as the district court correctly noted, that which corporate directors do subsequent to the commencement of a derivative action is not important for purposes of ruling upon the issue of pre-suit demand futility. *See Grossman*, 674 F.2d at 123 ("'The futility of making the demand required by Rule 23.1 must be gauged at the time the derivative action is commenced, not afterward with the benefit of hindsight.'") (quoting *Cramer v. General Telephone & Electronics Corp.*, 582 F.2d 259, 276 (3d Cir. 1978), *cert. denied*, 439 U.S. 1129 (1979)). Thus, the fact that the Fund joined KFS in motions to dismiss the complaint has no bearing on the ability of the Fund's directors to impartially review the merits of petitioner's cause of action.

Finally, petitioner alleges in paragraph 17(g) of her amended complaint (Pet. App. 93a) that demand would have been futile because an application of the demand rule to these circumstances would be inconsistent with the policy underlying section 20 of the 1940 Act (Pet. App. 94a). This allegation is completely without explication; not only does petitioner fail to specify the nature of the underlying policy of section 20(a), she gives no indication as to how a demand upon the Fund's directors in this case would jeopardize that policy. In the absence of any "particularity" to support her allegations in this regard, petitioner has failed to meet the pleading requirements of Rule 23.1.[4]

For all of these reasons, the decision of the lower court dismissing petitioner's amended complaint for failure to comply with the requirements of Rule 23.1 should be affirmed.

B. Petitioner Has Failed to Allege Director Involvement or Interest Sufficient to Excuse Demand Under a Principled Application of Maryland Law

Although not properly presented to either of the lower courts, petitioner contends in these proceedings that her allegations of director interest are sufficient under Maryland law to excuse her failure to make prior demand upon the Fund's directors. Petitioner has waived this argument. *See* footnote 1, *supra*. Moreover, even had this argument not been waived, it is without merit. Petitioner misunderstands

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[4] In addition, it is not clear that the substance of this allegation, even if pleaded with particularity, would support a finding of futility. Determinations regarding demand futility focus on the independence and disinterestedness of the corporate directors. Petitioner's paragraph 17(g) fails to make any factual allegations of director interest or bias.

the precedent upon which she premises her argument by improperly attempting to extract "blackletter" principles from those cases while ignoring the underlying factual foundation which gave rise to their findings of demand futility.

The requirement of pre-suit demand upon corporate directors in Maryland, and its futility exception, is settled law. In *Parish v. Maryland & Virginia Milk Producers Ass'n.*, 242 A.2d 512, 544 (1968), *cert. denied*, 404 U.S. 940 (1971), the Maryland Court of Appeals stated:

> It is well established that ordinarily the courts will not entertain a derivative suit by a stockholder on behalf of a corporation until it appears that the intra-corporate remedies have been unsuccessfully pursued by the complaining stockholder. This means that, generally speaking, the complaining stockholder must make demand upon the corporation itself to commence the action, and show that this demand has been refused or ignored. This general rule, however, is subject to a well-recognized exception, i.e., that no such prior demand is required when it would be futile. Our predecessors in *Eisler v. Eastern States Corporation*, 182 Md. 329, 333, 35 A.2d 118, 119 (1943) cited 14 *C.J. Corporations* § 1339 as stating the general rule as follows:
>
> "Before a stockholder may sue the Corporation to enforce and protect its rights or to redress wrongs to it, he must first make an earnest and unsuccessful effort to obtain remedial action by the Corporation itself, first by application to the directors, and then by application to the body of the stockholders. But he need not do so where the circumstances are such that an application would be futile."

Like most state and federal jurisdictions, Maryland requires particularized allegations of misconduct which go to the independence and disinterestedness of the directors upon whom demand would be made to justify a finding of futility. The relevant issue is whether the directors were so involved in the alleged wrongdoing that they could not possibly act independently in prosecuting the derivative litigation. If there is no foundation upon which director interest or involvement can be premised, there is no reason to assume that the directors would be unable to independently review the merits of the shareholder's proposed claim, and consequently, no reason to excuse demand. Petitioner's claim that her allegations of director interest justify a finding of demand futility cheapens this foundational premise of Maryland's futility exception, as is apparent from a comparison of her allegations with those found sufficient in the cases upon which she relies.

In *Parish*, the Maryland Court of Appeals considered a shareholder derivative complaint which contained particularized allegations of fraud, concealment, illegality, gross negligence, waste of corporate assets, and conspiracy to conceal losses on the part of the majority of the directors who were named as defendants in that case. Based on these allegations of director involvement in illegal activity and the presumption of director antagonism which they raised, the Maryland Court not surprisingly concluded that the directors who participated in those illegal activities would not be able to act independently in reviewing the propriety of their own conduct. *Parish*, 242 A.2d at 545.

Likewise, in *Zimmerman v. Bell*, 585 F. Supp. 512 (D. Md. 1984), the district court found demand excused where the complaint alleged that the company's directors actively participated in the wrongdoing by granting lucrative "golden parachute" contracts in order to perpetuate their

control over the corporation. In *Oldfield v. Alston*, 77 F.R.D. 735 (N.D. Ga. 1978), the court found demand excused under Maryland law where the plaintiff satisfactorily alleged that all trustees either actively participated in the wrongful transactions or ratified them with knowledge or notice of their illegality. Finally, in *Burt v. Danforth*, 742 F. Supp. 1043 (E.D. Mo. 1990), demand was excused where the complaint alleged that various of the directors had aided and abetted illegal activity, fraudulently overcharged the U.S. government, and permitted the company to illegally obtain U.S. Defense Department confidential information.

Petitioner's amended complaint describes no such director interest or involvement. Rather, she argues that demand should be excused because the Fund's directors sent out the allegedly "false" proxy statement (Pet. Br. 11).[5] There is no question that the Fund's directors did participate in the distribution of the proxy statement. Because this is alleged as an act of wrongdoing, however, it is instructive to note that petitioner has failed to present other facts which cast this participation in a "fraudulent" light. Certainly there are no allegations, particularized or otherwise, of affirmative wrongdoing—*i.e.*, wrongful conduct affirmatively undertaken for purposes of self-enrichment or protection. Nor are

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[5] In her brief to this Court, petitioner also characterizes her section 20(a) claim as "proxy fraud" (Pet. Br. at 11), a term conspicuously absent from her offerings in either court below. *Rosengarten v. Buckley*, 565 F. Supp. 193 (D. Md. 1982), which petitioner cites in support of her position, also wisely counsels that courts will look carefully to see if fraud is actually involved before demand will be excused. "Of course, a plaintiff may not escape the demand requirement by characterizing a suit which is really based on a breach of fiduciary duty as a fraud action." 565 F. Supp. at 198.

there any particularized allegations of fraud. *See Zimmerman, Oldfield, Burt, supra.*

In addition, petitioner alleges that demand futility has been shown because of the fact that the Fund's directors caused the Fund to oppose the action on the merits (Pet. Br. 12). There appear to be no reported cases applying Maryland law deciding whether *post-litem* director opposition is sufficient reason to excuse pre-suit demand. There is also no reason to believe that Maryland courts would not follow the overwhelming weight of authority rejecting such an argument. *See Grossman,* 674 F.2d at 123; *Cramer,* 582 F.2d at 276.

The fatal flaw in petitioner's argument is that she separates the holding of *Parish* from its underlying facts and, in so doing, strips that decision of its foundational premise. If the holding in *Parish* is to have any principled parameters—that is, if the court's decision in *Parish* is premised upon a discernable level of director self-interest which can be presumed from the allegations of wrongful director conduct—then the underlying facts of that case must be considered in reviewing the allegations of futility in other cases. Surely, the Maryland Court of Appeals did not intend its fact-based *Parish* decision to place corporate affairs in the hands of dissident shareholders and their counsel on the flimsy grounds pleaded in this case.

II. THE FUTILITY EXCEPTION TO THE DEMAND REQUIREMENT IN SHAREHOLDER DERIVATIVE LITIGATION PREMISED UPON FEDERAL QUESTION JURISDICTION SHOULD BE ABOLISHED

In addition to affirming the district court's judgment that petitioner failed to allege sufficient excuse for pre-suit demand, the Seventh Circuit reached the conclusion that

allegations of futility could not excuse a shareholder's failure to make a demand on a corporation's board prior to instituting derivative litigation in federal question cases. This determination, based on a thoughtful analysis of the role of demand in modern derivative litigation, should be affirmed by this Court.

A. The Seventh Circuit Properly Held that Federal Common Law Governs Issues Concerning the Necessity of Demand in Federal Question Cases

The foundation of the demand requirement in shareholder derivative litigation is firmly rooted in the federal common law. As originally envisioned by this Court in *Hawes v. Oakland,* 104 U.S. 450 (1881), pre-litigation shareholder demand upon a corporation's directors was an "exhaustion" requirement.[6] Based on this precedent and that of other federal courts, and commentators who have considered the issue, the Seventh Circuit rightly concluded that federal common law governs issues concerning the necessity and sufficiency of demand in federal question cases (Pet. App. 9a). *See* Wright, Miller and Kane, *Federal Practice and Procedure: Civil 2d* § 1831, p. 100 (1986) ("[f]ederal law governs the issue whether plaintiff has made sufficient demand on the directors."); *Sax v. World Wide Press, Inc.,* 809 F.2d 610, 613 (9th Cir. 1987); *Kaster v. Modification Systems, Inc.,* 731 F.2d 1014, 1017-18 (2d Cir. 1984); *Greenspun v. Del E. Webb Corp.,* 634 F.2d 1204, 1208-10 (9th Cir. 1980); *In re Kaufman Mutual Fund Actions,* 479

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[6] This Court stated, "before the shareholder is permitted in his own name, to institute and conduct a litigation which usually belongs to the corporation, he should show . . . that he has *exhausted* all the means within his reach to obtain, within the corporation itself, the redress of his grievances. . . ." *Id.* at 462-63 (emphasis supplied).

F.2d 257, 263 (1st Cir. 1973). *See also Meltzer v. Atlantic Research Corp.*, 330 F.2d 946, 948 (4th Cir.), *cert. denied*, 379 U.S. 841 (1964) ("[t]he necessity and sufficiency of the preliminary demand upon the directors, and the circumstance which satisfies omission of such demand under Rule 23(b) would seem to be procedural in nature and hence governed by Federal law.").[7]

Both petitioner and the SEC contend that this Court's decision in *Burks v. Lasker*, 441 U.S. 471 (1979), mandates application of the various states' laws to the issue of demand futility, even when it arises in the federal courts in the context of federal question litigation (Pet. Br. 8-11; SEC Br. 16-19). Indeed, the SEC posits that state law should uniformly apply to issues surrounding the demand requirement because this is an area where "the States enjoy primary responsibility." (SEC Br. 16). This contention demonstrates a fundamental misperception of the premise underlying this Court's decision in *Burks* and the impact, or lack thereof,

[7] The requirement for pre-litigation demand originally set forth in *Hawes* has been engrafted into successive generations of federal rules, culminating with its present codification in Rule 23.1. *See Daily Income Fund, Inc. v. Fox*, 464 U.S. 523, 530 n.5 (1984). While uniformly enforced through the present day, it is not clear whether the demand requirement of Rule 23.1 is procedural, substantive or both. *See generally Gaubert v. Federal Home Loan Bank Board*, 863 F.2d 59, 63 and n.2 (D.C. Cir. 1988); *In re Consumers Power Company Derivative Litigation*, 111 F.R.D. 419, 423 (E.D. Mich. 1986) (in diversity cases demand is both procedural and substantive). This Court left that issue unresolved in *Fox*, 464 U.S. at 532 n.8. *But, cf.*, 464 U.S. at 543-44 (Rule 23.1 is concerned solely with the adequacy of the pleadings and creates no substantive rights) (Stevens, J., concurring). Whether the rule is substantive or procedural, there can be no doubt as to its wisdom.

which that premise has on the issue of demand in federal courts.

In *Burks*, this Court was presented with the question of whether disinterested directors of an investment company had the power to terminate derivative litigation brought by a shareholder against other directors. The resolution of this issue required the Court to address questions which directly implicated an area of traditional state concern: the right of a board of directors to terminate litigation. Indeed, this Court described state law as "the font of corporate directors' powers." 441 U.S. at 478. Because of the states' interest in this issue, this Court resolved the issue presented in *Burks* by first referring to state law.

The recognition of the state interest which guided this Court's analysis in *Burks* does not impact the resolution of the issue presented today. In fact, the issue resolved by this Court in *Burks* is confronted only after the procedural demand hurdle has been cleared.[8] As originally conceived by this Court in *Hawes v. Oakland*, pre-litigation demand was an "exhaustion" requirement, a non-juridical station through which a shareholder must proceed before being permitted to pursue his litigation against the corporation. The fundamental concern of corporate governance upon which this Court premised its decision in *Burks*—whether the board of directors may terminate litigation—simply does

[8] This Court held in *Burks* that federal courts should apply state law when confronted with questions concerning "*the authority of independent directors to discontinue* derivative suits. . . ." 441 U.S. at 486 (emphasis added). Decisions to continue or discontinue derivative suits are one step removed from a shareholder's demand which simply raises the issue for directorial consideration. If a demand is made, such a decision may never be reached. *See* p. 22, *infra*.

not enter into the equation of whether or not demand should be required in a particular situation.

Only federal interests are implicated in issues concerning demand in federal courts. Foremost among those interests is a federal court's legitimate interest in efficiently and effectively structuring the proceedings which govern shareholder derivative litigation. The Seventh Circuit's abolition of the futility exception in federal question cases is no more than an attempt to achieve this legitimate federal interest.

B. The Evolution of the Federal Common Law in this Context Should Not Be Thwarted by Reference to Precedent Which Has Not Considered the Precise Issue Before this Court

Petitioner portrays the Seventh Circuit's decision as "revolutionary" and in conflict with the precedent of this Court and other federal courts. Yet she is unable to point to any decision of this Court or any other federal court which has directly addressed the issue of the continued viability of the futility exception.[9] It is true that the Seventh Circuit's forward-moving decision stands alone among federal decisions in its treatment of the futility exception. A decision which stands alone, however, is not necessarily unsupported as petitioner would have this Court believe. Indeed, within the context of an evolving federal common law, the truly evolutionary decision must always stand alone for at least a

[9] In *Johnson v. Hui*, 752 F. Supp. 909 (N.D. Cal. 1990), the District Court for the Northern District of California declined the opportunity to follow the lead of the Seventh Circuit in abandoning the futility exception in shareholder derivative litigation. The district court noted that Ninth Circuit precedent which governs its decisions still recognizes the futility exception in certain limited circumstances.

short while. If the evolution is warranted, other decisions soon follow in its footsteps. In this case, an examination of the policies supporting the Seventh Circuit's abolition of the futility exception, and the benefits to be derived from such an abolition, indicate that the Seventh Circuit's action is truly warranted.

C. Abandonment of the Futility Exception in Federal Derivative Litigation Promotes Judicial Efficiency in Resolving the Merits of Those Disputes While Fostering Other Forms of Intracorporate Dispute Resolution

Increased efficiency in the context of shareholder derivative litigation is achieved through the federal courts' ability to modify the common law surrounding the federal demand requirement in a manner which it deems best suited to achieving the desired result. The opinion of the Seventh Circuit in this case makes just such a modification. Specifically, the Seventh Circuit's abolition of the futility exception in federal derivative litigation reinvigorates the demand requirement by restoring its ability to achieve the salutary goals initially envisioned for it.[10] The rule is simple: share-

[10] A comprehensive summary of the purposes underlying the demand requirement in shareholder derivative litigation is found in *Mills v. Esmark, Inc.*, 91 F.R.D. 70, 72 (N.D. Ill. 1981), wherein the court stated:

> The purpose of the demand requirement of Rule 23.1 is to allow a corporation to activate intracorporate remedies to address shareholder complaints prior to resorting to judicial intervention. . . . In theory, this salutary policy inures to the benefit of all involved. The dissident shareholder is provided with an opportunity to achieve his goal without incurring the expense of litigation; the directors of the corporation are allowed to occupy their status as managers of the corpora-

holders bringing derivative claims in federal court premised upon federal question jurisdiction must always make a prior demand upon the corporation's directors. The policies which support it are strong: judicial efficiency in resolving the disputes underlying derivative claims is increased and alternative forms of intracorporate dispute resolution are encouraged.

One recognized purpose of the demand requirement is that of limiting shareholder access to federal courts for redress of derivative claims.[11] The futility exception has stripped the demand requirement of its ability to fulfill this purpose. Indeed, the practical impact of the futility exception has been to swing the pendulum in the other direction: shareholders have greater access to federal courts, oftentimes on issues, such as the issue presently under discussion, which do not help resolve the merits of the underlying derivative claim.[12] The Seventh Circuit noted this fact when

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> tion's affairs; the corporation is left to clean its own house, free from judicial entanglements; and the courts are relieved of the burden of prematurely resolving intracorporate disputes.

These purposes have been well-recognized by this Court and other federal courts for over a century. *See Hawes*, 104 U.S. at 461-62; *Daily Income Fund, Inc. v. Fox*, 464 U.S. 523, 532-33 (1984); *Lewis v. Graves*, 701 F.2d 245, 247 (2d Cir. 1983); *Cramer v. General Tel. & Electronics Corp.*, 582 F.2d 259, 275 (3d Cir. 1978), *cert. denied*, 439 U.S. 1129 (1979).

[11] In *Fox*, 464 U.S. at 531, this Court observed that the prerequisites to bringing derivative suits first announced in *Hawes* were intended, in part, "to maintain derivative suits as a limited exception to the usual rule that the proper party to bring a claim on behalf of the corporation is the corporation itself. . . ."

[12] Fundamental to the argument in support of a continued recognition of the futility exception is the presumption that

it stated, "[i]t is easy to point to hundreds of cases, including this one, in which the demand requirement was itself the centerpiece of the litigation." (Pet. App. 9a).[13]

Under the Seventh Circuit's rule, a shareholder's derivative claim will be resolved in one of three ways: (1) the corporation and the shareholder may pursue alternative forms of intracorporate dispute resolution; (2) the corporation may choose to act on the shareholder's demand and pursue and control the proposed litigation; or (3) the corporate directors may recommend that the shareholder's de-

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directors who are "biased" in some way against shareholder-challenged conduct are unable to independently review the merits of the shareholder's proposed litigation. This presumption, when coupled with the disincentive to bring demand which is inherent in some jurisdictions' demand/futility rules, serves only to encourage shareholders to forego a prior demand and allege futility. *See Bach v. National Western Life Ins. Co.*, 810 F.2d 509, 513 (5th Cir. 1987) ("[t]he incentives of the Delaware rule are apparent: it discourages the making of demands and the delegation of investigative duties to the most independent directors."). Once futility is alleged, the threshold issue often becomes a fact-specific inquiry into the "bias" of the corporation's directors towards the shareholder's proposed litigation. The problem: neither of these predictable consequences of the futility exception advances the merits of the litigation or otherwise brings the parties together in some form of intracorporate dispute resolution.

[13] Also cognizant of this problem, the American Law Institute ("ALI") has observed, "[t]he futility exception, while generally recognized, is nonetheless ambiguous in scope and has proven a prolific generator of litigation." *Principles of Corporate Governance: Analysis and Recommendations*, § 7.03, comment a at 64 (Tent. Draft No. 8, 1988). The ALI goes on to state, "[w]hatever the standard used to state the futility exception, close questions are inevitable and consequent litigation predictable over the necessity of demand." *Id.*

mand be refused. Each of these scenarios achieves a more efficient resolution of the shareholder's derivative claim than is presently achieved under rules which excuse demand based on allegations of futility.

Pre-litigation demand which leads to alternative forms of intracorporate dispute resolution presents the best of all possible choices: the allegations underlying the shareholder's demand are addressed, the corporation and the shareholder are saved the time and treasure which would otherwise be spent in litigation, and the federal courts are relieved of the burden of needless litigation over hypothetical questions of "director bias" which necessarily accompany a shareholder's allegation of demand futility. Moreover, as noted by the court in *Gaubert*, 863 F.2d at 65, "the demand for relief may alert the board to problems of which it was unaware, and may cause it to champion the complainant's cause more directly, more efficiently and/or more effectively than the shareholder could have done alone. . . ."[14]

Likewise, if the corporation chooses to accept demand and pursue the litigation on its own behalf, the shareholder is substantially better off than if he had opted to allege demand futility. The litigation which results will focus directly upon the shareholder's allegations of wrongdoing rather than attempting to answer hypothetical questions

[14] This case presents a compelling example of a case which might have been quickly and easily resolved by a demand. Prior to petitioner's filing of her complaint, a number of options were available for intracorporate resolution of her dispute. Had the Fund's directors been made aware of Kamen's claim at the time she was contemplating her lawsuit, the Fund's directors might have taken action to satisfy her. Unfortunately, petitioner's haste to the courthouse precluded the directors from being able to respond to petitioner's complaint in a non-litigious manner.

about the ambiguous concept of demand futility. Indeed, even in those situations where the corporation opts to refuse demand, requiring the shareholder to make demand in the first instance promotes judicial efficiency in the resolution of the merits of the derivative claim by avoiding the need for peripheral litigation over the issue of demand futility. In a situation such as this, where demand is alleged to be excused, substantial resources have been consumed in litigation on the collateral issue of futility, without ever making strides towards the actual merits of the dispute. The same will not be true under a uniform federal rule which requires demand in all instances—*i.e.*, if futility is never an excuse, the focus of the litigation begins and ends with the merits of the underlying dispute.[15]

The Seventh Circuit stated, "[i]f demand is useful, then let the investor make one; if indeed futile, the board's response will establish that soon enough. In either case, the litigation may proceed free of arguments about whether a demand should have been made in the first place." (Pet. App. 15a). Petitioner thinks such an approach naive (Pet. Br. 19). The benefits to be derived from this approach and the sound jurisprudential policies which support it demonstrate otherwise.

D. The Rule of Demand Adopted by the Seventh Circuit will Present No Impediment to the Proper Resolution of Derivative Claims.

Contrary to petitioner's assertions, the adoption of a uniform rule requiring demand in all circumstances in

[15] Like the SEC (SEC Br. 29 n.23) and KFS (KFS Br. 23 n.15), the Fund submits that this case does not present the proper vehicle for determining what standard of review should be applied once a demand has been made and declined.

federal cases will neither spell the death of derivative litigation, nor present "insuperable obstacles to the enforcement of federal rights" (Pet. Br. 18). Rather, the requirement of demand advanced by the Seventh Circuit will place the responsibility for corporate decision-making where it belongs in the first place, while at the same time enabling corporations and federal courts to concentrate their respective resources on the functions for which each is best suited.[16]

Petitioner's gloomy forecast is premised upon a fundamentally faulty assumption that the adoption of such a requirement in federal jurisprudence necessarily entails a deferential standard of review for determining the reasonableness of a board's failure to bring suit. The fatal flaw of this assumption is that it ignores the underpinnings of the decision upon which it is based. Under the demand requirement adopted by the Seventh Circuit, the making of a demand is not in any way linked to the standard of review which may subsequently be applied to a board's decision not to sue. The court expressly stated, "when the demand

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[16] The First Circuit recognized as much when it stated, "[a]fter a demand provides them with 'full knowledge for the basis for the claim,' (citation omitted), *it is for the directors*, who have 'the advantage of familiarity with the enterprise, with those who have conducted it and with the record of success or failure' *to decide the appropriate corporate response*." *In re Kauffman Mutual Fund Actions*, 479 F.2d at 266-67 (citation omitted) (emphasis supplied). As the Seventh Circuit aptly noted, "[c]hoosing between litigation and some other response may be difficult, depending on information unavailable to the courts and a sense of the situation in which business executives are trained. Managers who make such judgment calls poorly ultimately give way to superior executives; no such mechanism 'selects out' judges who try to make business decisions." (Pet. App. 10a).

requirement comes from federal common law, the making of a demand does not affect the standard of review with which the court will assess the board's decision not to sue." (Pet. App. 13a).[17]

Moreover, while complaining of a veritable nightmare of "insuperable obstacles" and "tremendous impediments" which she claims will result from the demand rule adopted by the Seventh Circuit, petitioner cites but one Delaware case in support of her argument. In *Kaplan v. Wyatt*, 484 A.2d 501 (Del. Ch. 1984), *aff'd*, 499 A.2d 1184 (1985), the Delaware Supreme Court affirmed a trial court decision dismissing a derivative case on the recommendation of a special litigation committee that conducted an exhaustive investigation of the claims after suit was filed. The case turned on whether the lower court correctly applied the two-step analysis described in *Zapata Corp. v. Maldonado*, 430 A.2d 779 (1981). *Kaplan* did not decide an issue of pre-suit demand, and it does not support petitioner's argument.

First, the issue in *Kaplan* was whether the lower court determined and applied the proper standard of review—an issue not reached in the Seventh Circuit's analysis. Second, petitioner seems to complain that the *Kaplan* investigation was too long, too costly, and too thorough. Here again, she has missed the point. An investigation will be conducted, either at the corporation's expense prior to suit or at everyone's expense (including the court's) after suit is filed. Pre-suit demand is the issue in this case, and petitioner has made no showing of any meaningful obstacle or impediment

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[17] This severance of the link between the making of demand and the applicable standard of judicial review comports with the ALI's judgment that "the need for demand and the standard of judicial review are logically distinct." *Principles of Corporate Governance*, § 7.03, comment a at 65 (Tent. Draft No. 8, 1988).

to a valid claim by a minority shareholder under the demand rule adopted by the Seventh Circuit.

Petitioner concludes by quoting a passage from Fund director David Belin's deposition. The key element of this independent director's testimony was that if petitioner had brought her claim to the Fund prior to suit, he would have considered it (Pet. Br. 23-26). Petitioner cites no deposition testimony from this or any other director to the effect that her pre-suit demand would have been futile, because there was none.

Petitioner's predictions of "gloom and doom" resulting from the adoption of the Seventh Circuit demand rule are no more particularized than were the allegations of futility contained in her amended complaint—and they deserve the same fate.

III. THE ARGUMENT RAISED ONLY BY THE SECURITIES AND EXCHANGE COMMISSION IN ITS *AMICUS* BRIEF THAT PROXY CLAIMS UNDER SECTION 20(A) ARE NOT DERIVATIVE IS NOT PROPERLY BEFORE THIS COURT.

The Securities and Exchange Commission seeks through its *amicus* brief in these proceedings to further its own agenda with respect to an issue which is not properly before this Court. Specifically, the SEC urges this Court to reverse the decisions of both federal courts below and remand this case on the uncertified ground that petitioner's proxy claim is not derivative for purposes of Fed. R. Civ. P. 23.1. Respondent KFS's brief on this appeal carefully analyzes the SEC's arguments and demonstrates conclusively why this Court should not consider them (KFS Br. Sec. IV).

The Fund agrees with the KFS analysis and, accordingly, adopts the KFS brief and argument on this issue.[18]

The SEC speaks of the value of "private enforcement" as a supplement to Commission action in the context of securities regulation (SEC Br. 1). In the next breath, however, the SEC proposes a rule which would deny corporations standing to protect their rights under the securities laws, leaving the field to shareholders as the sole private guardians of the corporate interest in connection with proxy solicitation claims. If the SEC's goal is to encourage private enforcement of securities laws, wisdom would suggest a regulatory scheme which permits the party most directly interested to vindicate its rights.

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[18] The Fund wishes to emphasize that adoption of the SEC's argument would render corporations powerless to protect their legitimate interests in the securities field. The rule proposed by the SEC is not limited in application to the proxy claims brought under the 1940 Act. Rather, it appears to place limitations on the rights of *all* corporations to bring proxy claims, whether under section 20 of the Investment Company Act, section 14 of the Securities and Exchange Act of 1934, or any statutory provision dealing with proxy solicitation. Thus, for example, a target corporation would no longer be permitted to protect its legitimate interest in making sure that its shareholders receive truthful information in the proxies distributed by an acquiring corporation or its agents.

CONCLUSION

For the foregoing reasons, the judgment of the United States Court of Appeals for the Seventh Circuit, affirming the dismissal of petitioner's section 20(a) claim, should be affirmed.

Respectfully submitted,

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